A Report
to the
Montana
Legislature

Financial-Compliance Audit

Montana State Fund

For the Two Fiscal Years Ended June 30, 2008

December 2008

Legislative Audit
Division

08-05A

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LEGISLATIVE AUDIT DIVISION

Tori Hunthausen, Legislative Auditor
Monica Huyg, Legal Counsel

Deputy Legislative Auditors
James Gillett
Angie Grove

December 2008

The Legislative Audit Committee
of the Montana State Legislature:

This report, along with our financial audit report (07-05), constitutes our financial-compliance audit report of the Montana State Fund, a component unit of the state of Montana, for the two fiscal years ended June 30, 2008. The objectives of this audit include determining whether the financial statements for each fiscal year 2007-08 and 2006-07 present fairly the Montana State Fund's and the State of Montana - Old Fund's financial position at June 30 for each fiscal year and the results of its operations for the fiscal years then ended.

We made one recommendation to the Montana State Fund in the prior audit report. This report contains no recommendations, and one disclosure issue related to accounting for MSF's new office building. On page A-3, you will find the independent auditor's report. We issued an unqualified opinion on the financial statements, which means the reader can rely on the information presented.

Montana State Fund's response to our audit is on page B-3. We thank the Montana State Fund staff for their cooperation and assistance during the audit.

Respectfully submitted,

/s/ Tori Hunthausen

Tori Hunthausen, CPA
Legislative Auditor

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Appointed and Administrative Officials

Montana State Fund	Laurence Hubbard	President/CEO
	Mark Barry	Vice President, Corporate Support
	Vacant	Vice President, Human Resources
	Richard Root	Vice President, Insurance Operations
	Peter Strauss	Vice President, Insurance Operations Support
	Nancy Butler	General Counsel
	Al Parisian	Chief Information Officer

State Fund Board of Directors

	Term Expires
Joe Dwyer, Chairman	2011
Jane Debruycker	2009
Thomas R. Heisler	2009
Ken Johnson	2009
James Swanson	2009
Boyd Taylor	2011
Wally Yovetich	2011

For additional information concerning the Montana State Fund, contact:

Laurence Hubbard, President/CEO
5 South Last Chance Gulch
Helena, MT 59601
(406) 444-6501

Report Summary

Montana State Fund

This report contains the results of our financial-compliance audit of the Montana State Fund New Fund (MSF) and the State of Montana - Old Fund for the two fiscal years ended June 30, 2008. We issued unqualified opinions on the statements for MSF and the State of Montana - Old Fund contained in this audit report. The financial audit of MSF and the State of Montana - Old Fund for the two fiscal years ended June 30, 2007, was issued in a separate report (07-05).

This report contains no recommendations and one disclosure issue related to accounting for MSF's new office building. The prior financial audit report contained one recommendation to MSF related to computer system access. The recommendation was implemented by MSF.

MSF personnel prepared the financial statements from the Statewide Accounting, Budgeting, and Human Resources System with adjustment. Adjustments are made to accurately present financial activity.

Chapter I – Introduction

Audit Objectives

We performed a financial-compliance audit of the Montana State Fund (MSF) for the two fiscal years ending June 30, 2008.

The objectives of this audit were to:

1. Determine whether MSF complied with selected state laws.
2. Obtain an understanding of the MSF's control systems to the extent necessary to support our audit of MSF's financial statements, and if appropriate, make recommendations for improvement in management and internal controls of MSF.
3. Determine whether the MSF's and the State of Montana-Old Fund's financial statements present fairly the financial position and results of operations for the fiscal year ended June 30, 2008, with comparative financial amounts for the fiscal year ended June 30, 2007.
4. Determine the status of prior audit recommendations.

Our financial audit of the MSF's and State of Montana - Old Fund's financial statements for the two fiscal years ended June 30, 2007, was issued in a separate report (07-05).

MSF personnel prepared the financial statements from the Statewide Accounting, Budgeting, and Human Resources System with adjustment. Adjustments are made to accurately present financial activity.

This report contains no recommendations and one disclosure issue related to accounting for MSF's new office building. Issues deemed not to have significant effect on operations have been discussed with management but are not included in this report.

Introduction

Montana State Fund is a nonprofit, independent public corporation that provides Montana employers with an option for workers' compensation and occupational disease insurance, and acts as the insurer of last resort. Montana State Fund is governed by a seven-member board of directors appointed by the governor. State law separates funding sources for claims incurred before July 1, 1990, (Old Fund) and those incurred on or after July 1, 1990, (New Fund).

Montana State Fund management must set premium rates for the New Fund at amounts sufficient, when invested, to carry the estimated cost of all claims to maturity, to meet the reasonable expenses of conducting the business of the New Fund, and to maintain a surplus over the amount produced by the National Association of Insurance Commissioners' risk-based capital requirements for a casualty insurer. The Old Fund costs are currently funded by investment earnings and investment principal. If Old Fund assets are insufficient, then, by law, the state General Fund will provide funding for claims. The investments of the Montana State Fund New Fund and the Old Fund are managed by the Montana Board of Investments and invested according to policies established in law.

Prior Audit Recommendations

We performed the prior audit of the Montana State Fund for the two fiscal years ended June 30, 2007. The report contained one recommendation concerning computer system access. Montana State Fund implemented the recommendation.

Chapter II – Disclosure Issue

Accounting for New Office Building

The Constitution of the State of Montana specifies assets of the state compensation insurance fund, herein referred to as Montana State Fund (MSF), be managed under the state's unified investment program. State law further provides the unified investment program be administered by the Montana Board of Investments. Montana Board of Investments records investment related transactions on MSF's accounting records.

On May 16, 2007, the Montana Board of Investments purchased land as an investment of MSF. Subsequently, the Montana Board of Investments entered into contracts for the design and construction of a building to be occupied by MSF for its operations, located on the land already purchased. In August 2008, MSF's board of directors affirmed the commitment to lease the building from Montana Board of Investments upon completion.

In April 2008, MSF employees requested input from Department of Administration's Accounting Division (accounting division) related to accounting for the building. In a series of communications in May 2008, accounting division advised all costs related to construction of the building should be recorded on MSF's accounting records as capital assets rather than investments, as required by generally accepted accounting principles. At the end of fiscal year 2007-08, the proper accounting treatment was still under dispute, so transactions to account for the costs in accordance with generally accepted accounting principles were not made. In November 2008, the Montana Board of Investments recorded transactions to MSF's accounting records to reflect the activity in accordance with generally accepted accounting principles. MSF adjusted its financial statements to properly reflect the activity.

This information is presented for disclosure purposes only, and we make no recommendation at this time.

Independent Auditor's Report and Montana State Fund and State of Montana - Old Fund Financial Statements

LEGISLATIVE AUDIT DIVISION

Tori Hunthausen, Legislative Auditor
Monica Huyg, Legal Counsel

Deputy Legislative Auditors
James Gillett
Angie Grove

Independent Auditor's Report

The Legislative Audit Committee
of the Montana State Legislature:

We have audited the accompanying Statements of Net Assets of the Montana State Fund and the State of Montana – Old Fund, a component unit of the state of Montana, as of June 30, 2008, and 2007, and the related Statements of Revenues, Expenses, and Changes in Fund Net Assets, Montana State Fund and State of Montana – Old Fund, and Statements of Cash Flows, Montana State Fund and State of Montana – Old Fund, for each of the fiscal years then ended. The information contained in these financial statements is the responsibility of the Montana State Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Montana State Fund and State of Montana – Old Fund as of June 30, 2008, and 2007, and the respective results of operations and cash flows for each of the fiscal years then ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying Management's Discussion and Analysis and Schedule of Funding Progress for MSF are not required parts of the financial statements, but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Respectfully submitted,

/s/ James Gillett

James Gillett, CPA
Deputy Legislative Auditor

November 21, 2008

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Montana State Fund and The State of Montana - Old Fund
Management's Discussion and Analysis,
Financial Statements, Notes, and
Required Supplementary Information

Montana State Fund
(A Component Unit of the State of Montana)
Management Discussion and Analysis
June 30, 2008 and 2007

Overview of the Financial Statements

This overview is an introduction to MSF and the Old Fund financial statements. The financial statements consist of two components: (1) basic financial statements, and (2) notes to the basic financial statements.

The statement of net assets presents information regarding all of MSF and Old Fund's assets and liabilities, with the difference between the two being reported as net assets.

The statements of revenue, expenses, and changes in fund net assets present the financial results of operations for MSF and the Old Fund for the two most recent fiscal years. This statement presents information showing how the net assets changed during the two most recent fiscal years. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of the cash flows. Thus, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods.

The statement of cash flows details the cash used and provided by the various activities of MSF during the fiscal year. However, this statement does not consider unpaid responsibilities which have been established by contract or other underlying events during the fiscal year.

The following analysis presents two years of comparative condensed financial data.

Analysis of Financial Position - MSF

The following is a comparison of the financial position of MSF at June 30, 2008 to 2007, (In thousands):

	6/30/2008	6/30/2007	Change
Assets:			
Cash and STIP	$23,286	$13,744	$9,542
Investments	952,604	868,027	84,577
Security Lending Collateral	143,711	146,413	(2,702)
Receivables (Net)	30,044	31,700	(1,656)
Capital Assets (Net)	10,049	6,772	3,277
Other Assets	38,168	25,883	12,285
Total Assets	1,197,862	1,092,539	105,323
Liabilities:			
Loss and LAE Reserves	752,253	679,209	73,044
Liability for Securities on Loan	143,711	146,413	(2,702)
Payables	19,368	18,627	741
Other Liabilities	57,978	46,685	11,293
Total Liabilities	973,310	890,934	82,376
Net Assets:			
Investment in Capital Assets	10,049	6,772	3,277
Unrestricted Net Assets	214,503	194,833	19,670
Total Liabilities and Net Assets	$1,197,862	$1,092,539	$105,323

Net Assets increased approximately $23.0M (million) from the prior year. The increase resulted from investment income of $34.0M. Investment income for the year includes unrealized losses on investments of $10.4M based on adjustment to the market value of the investments.

The change in book value of MSF's investment portfolio of fixed and equity securities in fiscal year 2008 was as follows, (In thousands):

Fiscal Year 2007 Book Value	$ 845,675
Purchases at Cost	202,311
Sales	(109,596)
Net Realized Losses	(113)
Net Accretion of Bonds	702
Fiscal Year 2008 Book Value	$ 938,979

Tillinghast-Towers Perrin, an independent actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of June 30, 2008 and June 30, 2007. Tillinghast-Towers Perrin provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected our best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2008 and 2007. The estimated claims payable is presented undiscounted, net of estimated reinsurance recoverable, at $752.3M and $679.2M, as of June 30, 2008, and June 30, 2007, respectively.

The following is a comparison of the financial position of MSF at June 30, 2007, to June 30, 2006, (In thousands):

	6/30/2007	6/30/2006	Change
Assets:			
Cash and STIP	$13,744	$14,919	($1,175)
Investments	868,027	738,858	129,169
Security Lending Collateral	146,413	132,439	13,974
Receivables (Net)	31,700	30,871	829
Capital Assets (Net)	6,772	6,601	171
Other Assets	25,883	17,313	8,570
Total Assets	1,092,539	941,001	151,538
Liabilities:			
Loss and LAE Reserves	679,209	590,688	88,521
Liability for Securities on Loan	146,413	132,439	13,974
Payables	18,627	19,727	(1,100)
Other Liabilities	46,685	40,562	6,123
Total Liabilities	890,934	783,416	107,518
Net Assets:			
Investment in Capital Assets	6,772	6,601	171
Unrestricted Net Assets	194,833	150,984	43,849
Total Liabilities and Net Assets	$1,092,539	$941,001	$151,538

Net Assets increased approximately $44.0M from the prior year. The increase has primarily resulted from an increase in investment income of $48.1M of which $22.0M was from unrealized gains on investments.

The change in book value of MSF's investment portfolio of fixed and equity securities in fiscal year 2007 was as follows, (In thousands):

Fiscal Year 2006 Book Value	$ 738,514
Purchases at Cost	254,171
Sales	(146,840)
Net Realized Gains	(656)
Net Amortization of Bonds	486
Fiscal Year 2007 Book Value	$ 845,675

MSF management has selected a best estimate within the range established by Tillinghast-Towers Perrin as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2007 and 2006. The estimated claims payable was presented undiscounted, net of estimated reinsurance recoverable, at $679.2M and $590.7M, as of June 30, 2007, and June 30, 2006, respectively.

Results of Operations – MSF

The following is a comparison of MSF's results of operations for fiscal year 2008 to fiscal year 2007, (In thousands):

	6/30/2008	6/30/2007	Change
Operating Revenues:			
Net Premium Earned	$230,965	$238,203	($7,238)
Total Operating Revenue	$230,965	$238,203	($7,238)
Operating Expenses:			
Benefits and Claims	201,333	208,627	(7,294)
Personal Services	22,984	19,507	3,477
Other Operating Expense	17,672	18,427	(755)
Total Operating Expense	241,989	246,561	(4,572)
Net Operating Income (Loss)	(11,024)	(8,358)	(2,666)
Nonoperating Revenue (Expense):			
Investment Income	44,264	37,294	6,970
Unrealized Gain/(Loss)	(10,366)	22,007	(32,373)
Other Nonoperating Revenue	72	79	(7)
Dividend Expense	0	(7,001)	7,001
Total Nonoperating Revenue (Expense)	33,970	52,379	(18,409)
Change in Net Assets	$22,946	$44,021	($21,075)

MSF's book of business decreased from $238.2M of net earned premium in fiscal year 2007 to $231.0M of net earned premium in fiscal year 2008. Net earned premium decreased by $7.2M compared to the prior year primarily due to a 1% rate decrease and the fact that MSF wrote fewer policies due to an increase in competition in the marketplace.

MSF did not pay a dividend in fiscal year 2008. This analysis was moved to later in the calendar year when fiscal year-end financial results are available. The Board will consider fiscal year 2008 results when determining if a dividend is declared in fiscal year 2009. MSF paid dividends of $7.0M to policyholders in fiscal year 2007. The Board of Directors, at its discretion, determines the amount of dividends to be declared.

Investment income, excluding unrealized gain/loss, increased by $7.0M in fiscal year 2008 over investment income earned in fiscal year 2007. This increase was primarily due to an increase in investment in fixed securities of $94.42M. In fiscal year 2008 MSF had a realized loss on the sales and maturities of investments of ($.1M) compared to a realized loss of ($.7M) on sales and maturities of investments in fiscal year 2007.

MSF experienced an unrealized loss on investments of ($10.4M) in fiscal year 2008, compared to an unrealized gain on investments of $22.0M in fiscal year 2007. This was primarily due to the decrease in fair value of equities of ($13.1M) in fiscal year 2008.

The following is a comparison of MSF's results of operations for fiscal year 2007 to fiscal year 2006, (In thousands):

	6/30/2007	6/30/2006	Change
Operating Revenues:			
Net Premium Earned	$238,203	$211,892	$26,311
Total Operating Revenue	$238,203	$211,892	$26,311
Operating Expenses:			
Benefits and Claims	208,627	192,699	15,928
Personal Services	19,507	18,974	533
Other Operating Expense	18,427	17,942	485
Total Operating Expense	246,561	229,615	16,946
Net Operating Income (Loss)	(8,358)	(17,723)	9,365
Nonoperating Revenue (Expense)			
Investment Income	37,294	32,141	5,153
Unrealized Gain/(Loss)	22,007	(20,640)	42,647
Other Nonoperating Revenue	79	133	(54)
Dividend Expense	(7,001)	(5,001)	(2,000)
Total Nonoperating Revenue (Expense)	52,379	6,633	45,746
Change in Net Assets	$44,021	($11,090)	$55,111

MSF's book of business grew from $211.9M in fiscal year 2006 to $238.2M in fiscal year 2007. Net Earned Premium increased by $26.3M compared to the prior year primarily due to economic growth in the state resulting in an increase in overall payroll levels, the basis for premiums.

MSF paid dividends of $7.0M to policyholders in fiscal year 2007, compared to $5.0 paid in fiscal year 2006.

Investment income, excluding unrealized gain/loss, increased by $5.2M in fiscal year 2007 over investment income earned in fiscal year 2006. This increase was primarily due to an increase in investment in fixed securities of $129.2M. In fiscal year 2007 MSF had a realized loss on the sales and maturities of investments of ($.7M) compared to a realized loss of ($.3M) on sales and maturities of investments in fiscal year 2006.

MSF experienced an unrealized gain on investments of $22.0M in fiscal year 2007, compared to an unrealized loss on investments of ($20.6M) in fiscal year 2006. This increase was due primarily to the increase in fair value of equities of $17.2M in fiscal year 2007.

Effects of Transactions with Other Parties

The State of Montana Board of Investments (BOI) is currently building office space for MSF by utilizing MSF invested assets. BOI purchased and holds title to the land. BOI has entered into a contract with Dick Anderson Construction, Helena, Montana and is coordinating and overseeing the construction of the building. BOI also entered in to an agreement with the City of Helena for leasing of up to 350 parking spaces in an adjacent parking garage that will be built by the city. The MSF Board of Directors have committed to occupying the building for MSF office space. Construction of the building began in August 2008 and is expected to be completed in the spring of 2010. The land cost plus interest is $1.14M and the cost of construction and related fees for the building is estimated to be $29.2M. (Note 10 in the Notes to the Financial Statements provides additional information.)

Analysis of Financial Position – Old Fund

The following is a comparison of the financial position of the Old Fund at June 30, 2008, to June 30, 2007, (In thousands):

	6/30/2008	6/30/2007	Change
Assets:			
Cash and STIP	$12,383	$7,862	$4,521
Investments	19,926	34,713	(14,787)
Security Lending Collateral	4,179	13,688	(9,509)
Receivables (Net)	381	574	(193)
Total Assets	36,869	56,837	(19,968)
Liabilities:			
Loss and LAE Reserves	68,435	75,063	(6,628)
Liability for Securities on Loan	4,179	13,688	(9,509)
Payables	767	720	47
Total Liabilities	73,381	89,471	(16,090)
Net Assets:			
Unrestricted Net Assets	(36,512)	(32,634)	(3,878)
Total Liabilities and Net Assets	$36,869	$56,837	($19,968)

Net Assets decreased ($3.9M) from the prior year. The primary reason for this decrease is the continuing development on remaining loss reserves increasing the estimated amount remaining to be paid on outstanding claims. The decreases in net assets have left a deficit in the net asset account of ($36.5M).

The change in book value of Old Fund's investment portfolio of fixed securities in fiscal year 2008 was as follows, (In thousands):

Fiscal Year 2007 Book Value	$ 34,927
Purchases at Cost	2,602
Sales	(19,046)
Net Realized Gains	135
Net Accretion of Bonds	(109)
Par Value Adjustment	86
Fiscal Year 2008 Book Value	$ 18,595

Tillinghast-Towers Perrin, an independent actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for the Old Fund as of June 30, 2008, and June 30, 2007. Tillinghast-Towers Perrin provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. State Fund management has selected our best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2008 and 2007. The estimated claims payable is presented discounted at $68.4M and $75.1M, as of June 30, 2008 and June 30, 2007, respectively. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield. The Old Fund discounted its actuarially determined unpaid balances by a factor of 4.5% for the period ended June 30, 2008, and 5.0% for the period June 30, 2007. The estimated claims payable undiscounted for fiscal years 2008 and 2007, respectively, is $86.7M and $98.2M.

The following is a comparison of the financial position of the Old Fund at June 30, 2007 to June 30, 2006, (In thousands):

	6/30/2007	6/30/2006	Change
Assets:			
Cash and STIP	$7,862	$8,676	($814)
Investments	34,713	43,252	(8,539)
Security Lending Collateral	13,688	14,894	(1,206)
Receivables (Net)	574	680	(106)
Total Assets	56,837	67,502	(10,665)
Liabilities:			
Loss and LAE Reserves	75,063	73,737	1,326
Liability for Securities on Loan	13,688	14,894	(1,206)
Payables	720	773	(53)
Total Liabilities	89,471	89,404	67
Net Assets:			
Unrestricted Net Assets	(32,634)	(21,902)	(10,732)
Total Liabilities and Net Assets	56,837	67,502	(10,665)

Net Assets decreased ($10.7M) from the prior year. The primary reason for this decrease is the continuing development on remaining loss reserves increasing the estimated amount remaining to be paid on outstanding claims. The decreases in net assets left a deficit in the net asset account of ($32.6M) as of June 30, 2007.

The change in book value of Old Fund's investment portfolio of fixed and equity securities in fiscal year 2007 was as follows, (In thousands):

Fiscal Year 2006 Book Value	$ 43,915
Purchases at Cost	3,017
Sales	(11,842)
Net Realized Gains	10
Net Accretion of Bonds	(173)
Fiscal Year 2007 Book Value	$ 34,927

State Fund management selected a best estimate within the range determined by Tillinghast-Towers Perrin as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2007 and 2006. The estimated claims payable is presented discounted at $75.1M and $73.7M, as of June 30, 2007 and June 30, 2006, respectively. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield. The Old Fund discounted its actuarially determined unpaid balances by a factor of 5.0% for the periods ended June 30, 2007 and June 30, 2006. The estimated claims payable undiscounted for fiscal years 2007 and 2006, respectively, is $98.2M and $97.8M.

Results of Operations – Old Fund

The following is a comparison of Old Fund's results of operations for fiscal year 2008 to fiscal year 2007, (In thousands):

	6/30/2008	6/30/2007	Change
Operating Expenses:			
Benefits and Claims	$4,659	$12,072	($7,413)
Personal Services	11	32	(21)
Other Operating Expense	1,401	1,336	65
Total Operating Expense	6,071	13,440	(7,369)
Nonoperating Revenue:			
Investment Income	1,852	2,253	(401)
Unrealized Gain/(Loss)	341	449	(108)
Other Nonoperating Revenue	0	5	(5)
Total Nonoperating Revenue	2,193	2,707	(514)
Change in Net Assets	($3,878)	($10,733)	$6,855

Benefits and Claims expense for fiscal year 2007 includes adverse development of $8.7M while the same expense for fiscal year 2008 includes $1.2M in adverse development.

State law (Section 39-71-2352, MCA) requires State Fund to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to $1.25M for both fiscal years 2008 and 2007. MSF allocated $1.25M in administration costs to the Old Fund in fiscal years 2008 and 2007. The Old Fund has a $126K (thousand) obligation to MSF in un-recovered administrative costs incurred in fiscal years 2008 and prior. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted $1.25M. The change in net assets for fiscal year 2008 is a reduction of ($3.9M) compared to a decrease of ($10.7M) in fiscal year 2007. For an explanation of this decrease in net assets see the Analysis of Financial Position – Old Fund section.

The following is a comparison of Old Fund's results of operations for fiscal year 2007 to fiscal year 2006, (In thousands):

	6/30/2007	6/30/2006	Change
Operating Expenses:			
Benefits and Claims	$12,072	$5,521	$6,551
Personal Services	32	53	(21)
Other Operating Expense	1,336	2,609	(1,273)
Total Operating Expense	13,440	8,183	5,257
Nonoperating Revenue:			
Investment Income	2,253	2,871	(618)
Unrealized Gain/(Loss)	449	(1,011)	1,460
Other Nonoperating Revenue	5	3	2
Total Nonoperating Revenue	2,707	1,863	844
Change in Net Assets	($10,733)	($6,320)	($4,413)

As allowed under the statute explained above, MSF allocated $1.25M in administration costs to the Old Fund in fiscal years 2007 and 2006. The Old Fund had a $321K obligation to MSF in un-recovered administrative costs incurred in fiscal years 2007 and prior. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted $1.25M.

The change in net assets for fiscal year 2007 is a reduction of ($10.7M) compared to a decrease of ($6.3M) in fiscal year 2006.

MONTANA STATE FUND
STATEMENT OF NET ASSETS
Montana State Fund is a component unit of the State of Montana

JUNE 30,	2008	2007
ASSETS		
Current Assets		
Cash and cash equivalents	23,285,799	13,744,136
Receivables, net	29,421,393	31,041,246
Due from primary government	8,042	13,411
Due from component units	614,802	611,577
Securities lending collateral	143,710,845	146,413,103
Other assets	38,167,896	25,883,738
Total Current Assets	235,208,777	217,707,211
Noncurrent Assets		
Investments	952,603,759	868,026,676
Notes and loans receivable	-	33,598
Equipment	4,863,684	4,559,954
Land	1,139,460	-
Construction Work in Progress	4,376,593	-
Accumulated depreciation	(3,469,305)	(2,760,981)
Intangible assets	3,138,414	4,972,722
Total Noncurrent Assets	962,652,605	874,831,969
Total Assets	1,197,861,382	1,092,539,180
LIABILITIES		
Current Liabilities		
Accounts payable	17,869,533	17,212,084
Due to primary government	1,386,975	1,415,043
Due to component units	111,803	-
Estimated claims payable	140,045,343	137,986,975
Compensated absences	1,231,568	1,310,087
Securities lending liability	143,710,845	146,413,103
Deferred revenue	9,842,296	10,216,394
Property held in trust	44,888,625	34,273,741
Total Current Liabilities	359,086,988	348,827,427
Noncurrent Liabilities		
Estimated claims payable	612,207,957	541,222,025
Compensated absences	1,156,747	884,566
OPEB Liability	858,215	-
Total Noncurrent Liabilities	614,222,919	542,106,591
Total Liabilities	973,309,907	890,934,018
NET ASSETS		
Invested in capital assets, net of related debt	10,048,846	6,771,695
Unrestricted	214,502,629	194,833,467
Total Net Assets	224,551,475	201,605,162
Total Liabilities and Net Assets	1,197,861,382	1,092,539,180

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND
STATEMENT OF REVENUES, EXPENSES, and CHANGES IN FUND NET ASSETS
Montana State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	**2008**	**2007**
Net premiums earned	230,965,307	238,202,708
Operating Expenses		
Benefits and claims	201,333,093	208,627,247
Personal services	22,984,130	19,506,793
Contractual services	8,943,666	13,480,301
Supplies and materials	634,314	910,424
Depreciation	668,018	453,815
Amortization	1,102,235	905,704
Rent and utilities	460,256	484,457
Communications	1,623,405	1,158,400
Travel	283,431	231,570
Repair and maintenance	928,390	875,434
Other operating expenses	3,028,599	(72,955)
Total Operating Expenses	241,989,537	246,561,190
Operating Loss	(11,024,230)	(8,358,482)
Nonoperating Revenue (Expenses)		
Investment income	32,974,730	59,893,136
Gain on sale of investments	282,605	167,506
Securities lending income	6,841,075	6,164,519
Loss on sale of investments	(396,128)	(823,312)
Securities lending expense	(5,803,640)	(6,100,391)
Penalties and interest	34,576	35,367
Loss on retirement of assets	-	(771)
Dividend expense	-	(7,000,966)
Other income	37,325	44,047
Total Nonoperating Revenue (Expense)	33,970,543	52,379,135
Change in Net Assets	22,946,313	44,020,653
Total Net Assets - Beginning	201,605,162	157,584,509
Total Net Assets - Ending	224,551,475	201,605,162

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND
STATEMENT OF CASH FLOWS
Montana State Fund is a component unit of the State of Montana

YEAR ENDED JUNE 30,	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts for premiums	231,697,573	239,497,771
Payments to suppliers for goods and services	(15,928,208)	(21,313,583)
Payments to employees	(21,906,284)	(19,216,620)
Cash payments for claims	(128,658,281)	(120,013,899)
Other operating receipts	71,902	79,414
Net Cash Provided by (Used for) Operating Activities	65,276,702	79,033,083
CASH FLOWS FROM NONCAPITAL FINANCIAL ACTIVITIES		
Payment of Dividends to Policyholders	-	(7,000,966)
Net Cash Provided by (Used for) Noncapital Financing Activities	-	(7,000,966)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Acquisition of fixed assets	(2,009,259)	(1,835,309)
Proceeds from sale of fixed assets	-	27,746
Net Cash Used for Capital and Related Financing Activities	(2,009,259)	(1,807,563)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investments	(204,419,392)	(253,443,251)
Proceeds from sales or maturities of investments	107,260,650	147,496,410
Proceeds from securities lending transactions	6,841,075	6,164,519
Payments of security lending costs	(5,803,640)	(6,633,239)
Interest and dividends on investments	42,395,527	35,016,071
Net Cash Provided by (Used For) Investing Activities	(53,725,780)	(71,399,490)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	9,541,663	(1,174,936)
CASH AND CASH EQUIVALENTS - JULY 1	13,744,136	14,919,072
CASH AND CASH EQUIVALENTS - JUNE 30	23,285,799	13,744,136

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND
STATEMENT OF CASH FLOWS
Montana State Fund is a component unit of the State of Montana

YEAR ENDED JUNE 30,	2008	2007
RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES		
Change in Net Assets	22,946,313	44,020,653
Adjustments to Reconcile Change in Net Assets to Net Cash Provided by (Used for) Operating Activities		
Depreciation	668,018	453,815
Amortization	1,102,235	905,704
Interest expense	-	-
Security lending costs	5,803,640	6,100,391
Security lending income	(6,841,075)	(6,164,519)
Interest on investment	(32,861,207)	(59,237,330)
Payments of Dividends to Policyholders	-	7,000,966
Payment to State of Montana	-	-
Decrease (increase) in		
Accounts receivable	1,819,347	937,944
Due from component units of the State of Montana	(189,292)	(88,961)
Due from Primary Government	5,369	17,188
Notes receivable	33,598	1,200
Other assets	(12,284,158)	(8,569,886)
Increase (decrease) in		
Accounts payable	664,059	(1,210,850)
Due to Primary Government	72,892	223,646
Deferred Revenue	(374,098)	(6,267,651)
Property held in trust	10,614,884	12,154,518
Estimated claims	73,044,300	88,521,000
Other Post Employment Benefits	858,215	-
Compensated absences	193,662	235,255
Total adjustments	42,330,389	35,012,430
Net Cash Provided by (Used for) Operating Activities	65,276,702	79,033,083

The notes to the financial statements are an integral part of this statement.

STATE OF MONTANA - OLD FUND
STATEMENT OF NET ASSETS
Montana State Fund is a component unit of the State of Montana

JUNE 30,	2008	2007
ASSETS		
Current Assets		
Cash and cash equivalents	12,383,308	7,861,757
Receivables, net	269,183	574,258
Due from component units	111,803	-
Prepaid Expenses	-	224
Securities lending collateral	4,179,153	13,687,883
Total Current Assets	16,943,447	22,124,122
Noncurrent Assets		
Investments	19,925,461	34,713,171
Total Assets	36,868,908	56,837,293
LIABILITIES		
Current Liabilities		
Accounts payable	151,212	108,096
Due to primary government	-	826
Due to component units	615,425	611,578
Estimated claims payable	7,201,713	10,353,698
Securities lending liability	4,179,153	13,687,883
Total Current Liabilities	12,147,503	24,762,081
Noncurrent Liabilities		
Estimated claims payable	61,233,197	64,709,380
Total Noncurrent Liabilities	61,233,197	64,709,380
Total Liabilities	73,380,700	89,471,461
NET ASSETS		
Unrestricted	(36,511,792)	(32,634,168)
Total Net Assets	(36,511,792)	(32,634,168)
Total Liabilities and Net Assets	36,868,908	56,837,293

The notes to the financial statements are an integral part of this statement.

STATE OF MONTANA - OLD FUND
STATEMENT OF REVENUES, EXPENSES, and CHANGES IN FUND NET ASSETS
Montana State Fund is a component unit of the State of Montana

YEAR ENDED JUNE 30,	**2008**	**2007**
Operating Expenses		
Benefits and claims	4,659,487	12,071,873
Personal services	11,020	32,176
Contractual services	1,064,611	864,563
Depreciation	40,306	48,467
Amortization	66,505	244,411
Other operating expenses	229,053	179,140
Total Operating Expenses	6,070,982	13,440,630
Operating Loss	(6,070,982)	(13,440,630)
Nonoperating Revenue (Expenses)		
Investment income	2,015,677	2,692,467
Gains on investments	140,185	13,402
Securities lending income	343,751	312,700
Losses on investments	(5,383)	(3,217)
Securities lending expense	(300,872)	(307,487)
Liability tax revenue	-	-
Total Nonoperating Revenue (Expenses)	2,193,358	2,707,865
Change in Net Assets	(3,877,624)	(10,732,765)
Total Net Assets - Beginning	(32,634,168)	(21,901,403)
Total Net Assets - Ending	(36,511,792)	(32,634,168)

The notes to the financial statements are an integral part of this statement.

STATE OF MONTANA - OLD FUND
STATEMENT OF CASH FLOWS
Montana State Fund is a component unit of the State of Montana

YEAR ENDED JUNE 30,	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Payments to suppliers for goods and services	(1,567,640)	(1,291,419)
Payments to employees	16,659	(53,530)
Cash payments for claims	(11,143,411)	(10,770,720)
Collection of payroll taxes	-	-
Net Cash Used for Operating Activities	(12,694,392)	(12,115,669)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investments	(3,805,054)	(3,016,775)
Proceeds from sales or maturities of investments	18,911,122	11,832,155
Proceeds from securities lending transactions	343,751	312,700
Payments of security lending costs	(345,865)	(321,824)
Interest and dividends on investments	2,111,989	2,495,259
Net Cash Provided by Investing Activities	17,215,943	11,301,515
NET DECREASE IN CASH AND CASH EQUIVALENTS	4,521,551	(814,154)
CASH AND CASH EQUIVALENTS - JULY 1	7,861,757	8,675,911
CASH AND CASH EQUIVALENTS - JUNE 30	12,383,308	7,861,757

The notes to the financial statements are an integral part of this statement.

STATE OF MONTANA - OLD FUND
STATEMENT OF CASH FLOWS

Montana State Fund is a component unit of the State of Montana

YEAR ENDED JUNE 30,	2008	2007
RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH USED FOR OPERATING ACTIVITIES		
Change in Net Assets	(3,877,624)	(10,732,765)
Adjustments to Reconcile Change in Net Assets to Net Cash Used for Operating Activities		
Security lending costs	300,872	307,487
Security lending income	(343,751)	(312,700)
Interest on investment	(2,150,479)	(2,702,652)
Decrease (increase) in		
Accounts receivable	25,829	36,776
Due from primary government	(111,803)	-
Other Assets	224	(224)
Increase (decrease) in		
Accounts payable	88,109	(75,478)
Due to component units	3,225	36,642
Due to primary government	(826)	826
Estimated claims	(6,628,168)	1,326,419
Total adjustments	(8,816,768)	(1,382,904)
Net Cash Used for Operating Activities	(12,694,392)	(12,115,669)

The notes to the financial statements are an integral part of this statement.

Montana State Fund
(A Component Unit of the State of Montana)
Notes to Financial Statements
June 30, 2008 and 2007

1. Summary of Significant Accounting Policies

Description of Business

The Montana State Fund (MSF) is a nonprofit, independent public corporation established under Title 39, chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. The Board has full power, authority, and jurisdiction in the administration of MSF as fully and completely as the governing body of a private mutual insurance carrier. MSF is attached to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as MSF. Hereafter, any reference to MSF refers to the New Fund or those claims occurring after July 1, 1990.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. If MSF is dissolved by an act of law, the assets held by MSF are subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA). MSF administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of funds and assets held by the Old Fund. Adequate funding of the Old Fund is the responsibility of the State of Montana and the state General Fund. No State of Montana General Fund money is used for MSF operations.

MSF and Old Fund financial statements are presented as a component unit in the State of Montana Comprehensive Annual Financial Report. The fiscal year 2008 and 2007 financial statements are presented in conformance with generally accepted accounting principles (GAAP), and Governmental Accounting Standards Board Statement 34 (GASB), which is a comparable format to the State of Montana Comprehensive Annual Financial Report.

Basis of Accounting

MSF and the Old Fund use the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations. Under the accrual basis, revenues are recorded in the accounting period earned, if measurable, and expenses are recorded in the period incurred, if measurable.

Cash and Cash Equivalents

Cash balances include demand deposits with the State Treasury. Cash equivalents are short-term, highly liquid investments that are both readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. MSF and the Old Fund participate in the Montana Board of Investments Short Term Investment Pool (STIP). STIP balances are highly liquid investments with maturities of 397 days or less with the exception of securities having rate reset dates. The STIP portfolio is carried at amortized cost or book value with market value approximating cost. MSF's STIP balance of $17.6M as of June 30, 2008, represents 0.75% of the total STIP. The Old Fund STIP balance of $12.9M as of June 30, 2008, represents 0.55% of the total STIP. MSF's STIP balance of $10.3M as of June 30, 2007, represents 0.37% of the total STIP. The Old Fund STIP balance of $7.0M as of June 30, 2007, represents 0.25% of the total STIP.

The STIP investments' credit risk is measured by investment grade ratings given individual securities. The BOI's policy requires that STIP investments have the highest rating in the short-term category by one of any Nationally Recognized Statistical Rating Organizations (NRSRO). The three NRSRO's include Standard and Poor's, Moody's Investors Service, and Fitch, Inc.

Investments

In addition to STIP investments, the BOI invests in long-term securities. Under the provisions of the state constitution, MSF and the Old Fund's invested assets are managed by the BOI. Securities are stated at fair value as defined and required by Governmental Accounting Standards Board (GASB) Statement Number 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools". Premiums and discounts are amortized using the straight-line method over the life of the securities. Net unrealized gains or losses on securities are included in net income in accordance with GASB 31.

The BOI follows the provisions of Governmental Accounting Standards Board (GASB) Statement No. 40 – Deposit and Investment Risk Disclosures. The investment risk disclosures are described in the following paragraphs.

Credit Risk

Credit risk is defined as the risk that an issuer or other counterparty to an investment will not fulfill its obligation. With the exception of the U.S. government securities, Montana State Fund's fixed income instruments have credit risk as measured by major credit rating services. This risk is that the issuer of a fixed income security may default in making timely principal and interest payments. The Board of Investment's policy requires MSF and Old Fund fixed income investments, at the time of purchase, to be rated an investment grade as defined by Moody's and/or Standard & Poor's (S&P) rating services. The U.S. government securities are guaranteed directly or indirectly by the U.S. government. Obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk and do not require disclosure of credit quality. The credit ratings are provided by S& P's rating services. If an S&P rating is not available, a Moody's rating has been used.

Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. As of June 30, 2008 and 2007, all the fixed income and other equity securities were registered in the nominee name for the BOI and held in the possession of the BOI's custodial bank, State Street Bank. The Equity Index investment and State Street Bank repurchase agreement were purchased in the State of Montana Board of Investment's name.

Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issuer. The MSF Investment Policy, requires credit risk to be limited to 3 percent in any one name except AAA rated issues will be limited to 6% while the Old Fund investment policy statement does not address concentration of credit risk. The MSF Investment Policy provides for "no limitation on U.S. government/agency securities". MSF also has specified certain client preferences. Investments issued or explicitly guaranteed by the U.S. government are excluded from the concentration of credit risk requirement.

For fiscal year 2008, MSF had concentration of credit risk exposure of 8.81% with Federal Home Loan Banks, 12.47% to the Federal National Mortgage Association (Fannie Mae) and 10.07% with the Federal Home Loan Mortgage Corp. (Freddie Mac). Due to a change in methodology, the fiscal year 2007 concentration of credit risk has been restated as 10.02% - Federal Home Loan Banks, 13.6% - Federal National Mortgage Association and 10.37% - Federal Home Loan Mortgage Corp. The fiscal year 2007 concentration of credit risk for the MSF was previously stated as 12.04% - Federal National Mortgage Association and 10.03% - Federal Home Loan Banks.

For fiscal year 2008, Old Fund had concentration of credit risk exposure to the Federal National Mortgage Association of 10.27%, Commercial Mortgage Trust of 6.96%, and Federal Home Loan Mortgage Corp. of 11.26%. Due to a change in methodology, the fiscal year 2007 concentration of credit risk has been restated as 8.49% - Commercial Mortgage Trust, 36.69% - Federal National Mortgage Association, and 9.10% - Federal Home Loan Mortgage Corp. The fiscal year 2007 concentration of credit risk was previously stated as 8.49% - Commercial Mortgage Trust, 35.88% - Federal National Mortgage Association and 7.06% - Federal Home Loan Mortgage Corp.

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The MSF and Old Fund investment policies do not formally address interest rate risk. In accordance with GASB Statement No. 40, the BOI has selected the effective duration method to disclose interest rate risk. This method, as provided by the custodial bank, is “An option-adjusted measure of a bond’s (or portfolio’s) sensitivity to changes in interest rates. Duration is calculated as the average percentage change in a bond’s value (price plus accrued interest) under shifts of the Treasury curve plus/minus 100 basis points. The effective duration method incorporates the effect of the embedded options for bonds and changes in prepayments for mortgage-backed securities (including pass-throughs, CMOs and ARMs).”

As of June 30, 2008 and 2007, MSF holds two Collateralized Debt Obligations (CDO). A CDO is security backed by a pool of bonds, loans and other assets. CDOs do not specialize in one type of debt but are often non-mortgage loans or bonds. These CDO positions include $10 million par in Aria II, 6.253%, 10/10/2012 and $4 million par in Galena 1, 5.463%, 01/11/2013. The MSF and Old Fund portfolios did not hold any structured financial instruments known as REMICs (Real Estate Mortgage Investment Conduits).

Corporate asset-backed securities are based on cash flows from principal and interest payments on underlying auto loan receivables, credit card receivables, and other assets. These securities, while sensitive to prepayments due to interest rate changes, have less credit risk than securities not backed by pledged assets.

As of June 30, 2008 and 2007, the MSF portfolio held three variable rate corporate bonds with a $19 million par. The MSF variable-rate securities float with LIBOR (London Interbank Offered Rate).

Montana State Fund
(A Component Unit of the State of Montana)
Notes to Financial Statements
June 30, 2008 and 2007

MSF and Old Fund investments are categorized below to disclose credit and interest rate risk as of June 30, 2008 and June 30, 2007. Credit risk reflects the bond quality rating, by investment type, as of the June 30 report date. If a bond investment type is unrated, the quality type is indicated by NR (not rated). Interest rate risk is disclosed using effective duration. Both the credit quality ratings and duration have been calculated excluding cash equivalents.

MSF
Credit Quality Rating and Effective Duration as of June 30, 2008

Security Investment Type		Fair Value	Credit Quality Rating	Effective Duration
Corporate Bonds (Rated)	$	469,446,158	A+	3.77
U.S. Government Direct Obligations		47,618,945	AAA	6.05
U.S. Government Agency		346,455,520	AAA	3.71
STIP (Unrated)		17,566,677	NR	NA
Total Fixed Income Investments		881,087,300		
Direct Investments				
Equity Index Fund	$	87,443,325		
Total Direct Investments		87,443,325		
Total Investments	$	968,530,625	AA	3.50
Securities Lending Collateral Investment Pool	$	143,710,845	NR	NA

Montana State Fund

(A Component Unit of the State of Montana)

Notes to Financial Statements

June 30, 2008 and 2007

Old Fund

Credit Quality Rating and Effective Duration as of June 30, 2008

Security Investment Type		Fair Value	Credit Quality Rating	Effective Duration
Corporate Bonds (Rated)	**$**	**5,392,763**	AA	**1.49**
U.S. Government Direct Obligations		**6,520,587**	**AAA**	**1.18**
U.S. Government Agency		**6,808,653**	**AAA**	**0.34**
STIP (Unrated)		**12,892,185**	**NR**	**NA**
Total Investments	**$**	**31,614,188**	**AAA**	**0.97**
Securities Lending Collateral Investment Pool	**$**	**4,179,153**	**NR**	NA

MSF and Old Fund investments are classified in risk Category 1 or as Not Categorized under State of Montana standards. Risk category 1 includes investments that are insured or registered, or securities held by the BOI or its agent in the BOI's name. Not Categorized includes investments held by broker-dealers under securities loans with cash collateral.

Under the provisions of state statutes, the BOI has, by a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank (SSB), to lend the BOI's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. During the period the securities are on loan, the BOI receives a fee and the custodial bank must initially receive collateral equal to 102% of the fair value of the securities on loan and must maintain collateral equal to but not less than 100% of the fair value of the loaned security. The BOI retains all rights and risks of ownership during the loan period.

The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality trust. The relationship between the average maturities of the investment pool and the BOI's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which the BOI could not determine. On June 30, 2008 and June 30, 2007, the BOI had no credit risk exposure to borrowers.

The following table presents the market values of the securities on loan and the total collateral held for fiscal years ended June 30, 2008 and June 30, 2007 for both MSF and the Old Fund:

	MSF		Old Fund	
	2008	2007	2008	2007
Securities on Loan - Market Value	311,869,774	201,895,993	9,629,058	13,442,243
Total Collateral Held	318,218,094	205,512,665	9,821,759	13,687,883

Interest income earned related to long-term securities on loan for MSF and Old Fund for the year ended June 30, 2008 was $6.8M and $331K respectively. Expenses related to long-term securities on loan for MSF and Old Fund for the year ended June 30, 2008 were $5.8M and $291K respectively.

Interest income earned related to long-term securities on loan for MSF and Old Fund for the year ended June 30, 2007 was $6.2M and $313K respectively. Expenses related to long-term securities on loan for MSF and Old Fund for the year ended June 30, 2007 were $6.1M and $307K respectively.

In November 2000, the Montana Constitution was amended to allow MSF to invest in equity securities, with the restriction that equity securities cannot exceed 25% of total investment book value. In May 2003, the BOI approved a policy statement to keep equities in the 8% to 12% range. As of June 30, 2008, equity securities in MSF include $68.4M at book value, enhanced by $19.0M in market value appreciation. As of June 30, 2007, equity securities in MSF include $68.4M at book value, enhanced by $32.1M in market value appreciation.

Additional investment information can be found in Note 2.

Receivables

At June 30, 2008, MSF's premium receivable and claim benefit recoveries balance is $20.5M, which is then reduced by estimated uncollectible receivables reported as an allowance for doubtful accounts of $2.7M leaving a net receivable balance of $17.8M. Other receivables include $11.4M in investment income due and $225K in notes and loans receivable, all of which is short term.

At June 30, 2007, MSF's premium receivable and claim benefit recoveries balance is $22.6M, which is then reduced by estimated uncollectible receivables reported as an allowance for doubtful accounts of $2.8M leaving a net receivable balance of $19.8M. Other receivables include $11.2M in investment income due and $101K in notes and loans receivable, of which $34K is long term.

Accounts receivable includes $8.9M at June 30, 2008 and $11.4M at June 30, 2007 for premium that has been Earned But Unbilled, (EBUB).

Accounts receivable in the Old Fund include medical and indemnity overpayments. Old Fund accounts receivable for year ended June 30, 2008 and June 30, 2007 were $1.52M and $1.29M, respectively. Estimated uncollectible receivables are reported as an allowance for doubtful accounts and are recorded at $1.25M and $1.28M for the years ended June 30, 2008 and June 30, 2007 respectively. Interest receivable of $279K at June 30, 2008 and $558K at June 30, 2007 represent investment income due.

Equipment, Accumulated Depreciation and Intangible Assets

Equipment is capitalized if the actual or estimated historical cost exceeds $5K. Depreciation expense is computed on a straight-line basis for equipment over a period of three to five years and amortization of intangible assets is computed on a straight-line basis over five years. Amortization of intangible assets is applied directly to the asset balance. All fixed assets are recorded in the MSF financials. Because MSF administers the Old Fund, the Old Fund does not carry fixed assets.

Land and Construction Work in Process

MSF through the BOI has invested in land with the intention of constructing a building. Initial building cost of $1.25M are recorded as construction work in process for the year ending June 30, 2008.

MSF is also implementing major software systems. Initial cost of $3.1M for purchasing and developing the software systems are also included in construction work in process. Additional information on the building can be found in Note 10.

Other Assets

Other assets include advances, prepaid expenses and deferred acquisition costs. Deferred acquisition costs are amounts incurred during the policy writing process that are recognized ratably over the related policy term.

Estimated Claims Payable

The estimated claims payable is established to provide for the estimated ultimate settlement cost of all claims incurred. Estimated claims payable is based on reported aggregate claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported (IBNR) claims. Tillinghast-Towers Perrin, an external actuarial firm, prepares an actuarial study that provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. State Fund management has selected our best estimates within that range as the estimated claims payable for both MSF and Old Fund. For additional disclosure related to the estimated claims payable, refer to Note 4.

Accounts Payable

Accounts payable is a short term liability account reflecting amounts owed for goods and services received by MSF.

Deferred Revenue

Deferred revenue reflects amounts received or billed in advance, but not yet earned for policies effective July 1, 2008 or July 1, 2007.

Property Held in Trust

Property Held in Trust consists of security deposits owed to certain policyholders and the reinsurance funds withheld account, a requirement of MSF's aggregate stop loss reinsurance contract. Additional information regarding the funds withheld account can be found in Note 3.

Net Assets

Net assets consist of the net excess or deficit of assets over liabilities. For additional information on distributions impacting total net assets see Note 7.

Premiums

The MSF Board of Directors approves premium rates annually. Generally, policies are effective for the term of the policy period not to exceed 12 months. Premium revenue is recognized over the term of the fiscal year, which runs from July 1 through June 30, as it is earned or when MSF is liable for coverage.

Policyholders are contractually obligated to pay certain premiums to MSF in advance of the period the premiums are earned. Premium advances are refundable when the policyholder's coverage is canceled and all earned premiums have been credited by MSF.

Basis of Presentation

The financial statements are presented in accordance with generally accepted accounting principles as prescribed by the GASB. MSF insurance operations are classified as an enterprise fund, proprietary fund type. MSF comprises only a part of the State of Montana's enterprise funds. The financial statements in this report reflect the financial position and results of operations and cash flows of MSF and Old Fund, not the State of Montana.

An enterprise fund is used to account for operations: (a) financed and operated in a manner similar to private business enterprises, where the legislature intends that the entity finance or recover costs primarily through user charges; (b) where the legislature has decided that periodic determination of revenues earned, expenses incurred or net income is appropriate; (c) where the activity is financed solely by a pledge of the net revenues from fees and charges of the activity; (d) when laws or regulations require that the activities' costs of providing services be recovered with fees and charges rather than with taxes or similar revenues.

Investments are presented in accordance to GASB Statement Number 31, "Accounting and Financial Reporting for Certain Investments and External Investment Pools." STIP is considered an external investment pool, which is defined as an arrangement that pools the monies of more than one legally separate entity and invests, on the participant's behalf, in an investment portfolio. STIP is also classified as a "2a7-like" pool. A 2a7-like pool is an external investment pool that is not registered with the Securities and Exchange Commission (SEC) as an investment company, but has a policy that it will, and does, operate in a manner consistent with the SEC's Rule 2a7 of the Investment Company Act of 1940. If certain conditions are met, 2a7-like pools are allowed to use amortized cost rather than fair value to report net assets to compute unit values. The BOI has adopted a policy to treat STIP as a 2a7-like pool. See Note 1, Basis of Accounting – Investments and Note 2 for further discussions of the effect of GASB 31.

2. Investments

The amortized cost and market value of MSF's fixed maturity and equity securities as of June 30, 2008, and June 30, 2007, are as follows:

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MSF

June 30, 2008	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Market Value
Government Direct-Indirect	$ 333,382,539	$ 8,771,946	$ 469,919	$ 341,684,566
Government Mortgage-Backed	52,966,201	211,637	787,941	52,389,897
Corporate Securities Asset-Backed	77,834,457	1,117,957	2,979,923	75,972,490
Other Corporate Securities	388,444,247	1,199,719	14,128,127	375,515,839
Other Securities	19,584,192	280,832	267,381	19,597,643
Equity Securities	68,406,677	19,036,648	-	87,443,325
STIP	15,926,865	-	-	15,926,865
Total	$ 956,545,179	$ 30,618,738	$ 18,633,292	$ 968,530,625

June 30, 2007	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Market Value
Government Direct-Indirect	$ 333,096,617	$ 1,009,249	$ 6,707,433	$ 327,398,433
Government Mortgage-Backed	16,058,517	20,149	172,469	15,906,197
Corporate Securities Asset-Backed	92,143,171	2,050,666	643,274	93,550,563
Other Corporate Securities	319,888,189	507,304	5,912,342	314,483,151
Other Securities	14,942,986	303,856	243,309	15,003,533
Real Estate Securities	1,139,460	-	-	1,139,460
Equity Securities	68,406,676	32,138,662	-	100,545,339
STIP	10,305,619	-	-	10,305,619
Total	$ 855,981,236	$ 36,029,886	$ 13,678,827	$ 878,332,295

The amortized cost and estimated market value of MSF's fixed maturity securities as of June 30, 2008 and June 30, 2007, are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

MSF

June 30, 2008

	Amortized Cost	Market Value
Due one year or less	$ 98,527,550	$ 98,644,698
Due after one year through five years	306,548,743	304,254,488
Due after five years through ten years	369,966,115	366,451,413
Due after ten years	113,096,093	111,736,701
Equity Securities	68,406,677	87,443,325
Total	$ 956,545,179	$ 968,530,625

June 30, 2007

	Amortized Cost	Market Value
Due one year or less	$ 40,188,690	$ 40,028,813
Due after one year through five years	314,848,836	312,243,506
Due after five years through ten years	367,205,417	360,136,543
Due after ten years	64,192,156	64,238,635
Real Estate Securities	1,139,460	1,139,460
Equity Securities	68,406,676	100,545,339
Total	$ 855,981,236	$ 878,332,295

During the fiscal year ending June 30, 2008, MSF realized gross gains from sales of securities of $283K and gross realized losses of $396K. During the fiscal year ending June 30, 2007, MSF realized gross gains from sales of securities of $168K and gross realized losses of $823K.

As discussed in Note 1, GASB 31 requires governmental entities to report their investments at fair value. Fair value is defined as the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The adjustment to fair value is reflected as an increase or decrease in investment income. During fiscal year 2008, investment income for MSF reflects a decrease of ($10.4M) due to the unrealized loss on long-term investments. Investment income for fiscal year 2007 reflects an increase of $22.0M due to the unrealized gain on long-term investments.

The amortized cost and market value of the Old Fund fixed maturity securities as of June 30, 2008 and June 30, 2007 are as follows:

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Old Fund

June 30, 2008	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Market Value
Government Direct-Indirect	$ 12,265,615	270,021	-	$ 12,535,636
Government Mortgage-Backed	776,024	17,581	-	$ 793,605
Corporate Securities Asset-Backed	3,533,815	16,194	13,293	$ 3,536,716
Other Corporate Securities	2,019,056	-	163,011	$ 1,856,045
Other Securities	1,203,458	-	-	$ 1,203,458
STIP	11,688,727	-	-	$ 11,688,727
Total	$ 31,486,696	$ 303,796	$ 176,304	$ 31,614,188

June 30, 2007	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Market Value
Government Direct-Indirect	$ 20,072,572	$ 909	$ 176,335	$ 19,897,146
Government Mortgage-Backed	1,185,000	4,362	1,473	$ 1,187,889
Corporate Securities Asset-Backed	11,644,729	59,300	61,553	$ 11,642,476
Other Corporate Securities	2,024,442	-	38,783	$ 1,985,659
Other Securities	-	-	-	$ -
STIP	6,995,425	-	-	$ 6,995,425
Total	$ 41,922,168	$ 64,571	$ 278,144	$ 41,708,596

The amortized cost and market value of the Old Fund fixed maturity securities as of June 30, 2008 and June 30, 2007 are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Old Fund

June 30, 2008

	Amortized Cost	Market Value
Due one year or less	$ 21,548,878	$ 21,637,181
Due after one year through five years	6,404,002	6,440,291
Due after five years through ten years	-	-
Due after ten years	3,533,815	3,536,717
Total	31,486,695	31,614,188

June 30, 2007

	Amortized Cost	Market Value
Due one year or less	$ 19,072,720	$ 18,985,938
Due after one year through five years	14,695,154	14,614,175
Due after five years through ten years	2,776,566	2,792,307
Due after ten years	5,377,729	5,316,176
Total	41,922,168	41,708,596

During the fiscal year ended June 30, 2008, the Old Fund realized $140K in gross gains from sales of securities and $5K in gross losses from sales of securities. During the fiscal year ended June 30, 2007, the Old Fund realized $13K in gross gains from sales of securities and $3K in gross losses from sales of securities.

During fiscal year 2008, the effect of GASB 31 on Old Fund investment income was a decrease of $341K due to unrealized losses on its long-term portfolio. The effect of GASB 31 on Old Fund investment income for fiscal year 2007 was an increase of $449K due to unrealized gains on its long-term portfolio.

3. Reinsurance

For the fiscal years ended June 30, 2008 and June 30, 2007, MSF ceded premiums to other reinsurance companies to limit the exposure arising from large losses. These arrangements consist of excess of loss contracts that protect against individual occurrences over stipulated amounts and an aggregate stop loss contract which protects MSF against the potential that aggregate losses will exceed expected levels expressed as a percentage of premium. The excess of loss contracts provide coverage of $95.0M for both fiscal years 2008 and 2007. During fiscal years 2008 and 2007, MSF retained the first $5.0M for the first layer of reinsurance coverage. Individual, per person coverage was provided up to $5.0M per any one individual loss for both fiscal years 2008 and 2007.

The term of the current aggregate stop loss contract is July 1, 2005 through June 30, 2008. The contract provides coverage based on MSF's premium levels at a maximum of $33.8M per year and a minimum of $28.5M, but in aggregate not to exceed 80.0% of the sum of the annual limits for all contract years. In the event reinsurers are unable to meet their obligations under either the excess of loss contracts or aggregate stop loss contract, MSF would remain liable for all losses, as the reinsurance agreements do not discharge MSF from its primary liability to the policyholders.

Premium revenue is reduced by premiums paid for reinsurance coverage of $14.7M and $14.9M in fiscal years 2008 and 2007, respectively. The aggregate stop loss contract requires that MSF maintain a funds withheld account which represents the basic premium portion of the total premium paid for aggregate stop loss coverage. The total funds withheld account at June 30, 2008 is $40.9M for contracts in place from July 1, 2002 to June 30, 2008. The funds withheld account at June 30, 2007 was $29.7M for contracts in place from July 1, 2002 to June 30, 2007. Interest must be accrued quarterly at an annual rate of 5.0% for the fiscal years 2008 and 2007 funds withheld account, resulting in accrued interest of $2.1M for fiscal year 2008 and $1.6M for fiscal year 2007.

Estimated claim reserves were reduced by $14.0M and $10.0M for fiscal years 2008 and 2007 respectively for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the excessive loss reinsurance contract. In fiscal year 2008 estimated claim reserves were reduced by an additional $10.8M and in fiscal year 2007 an additional $8.6M for the amount of reinsurance estimated to be ultimately recoverable on incurred losses due to the aggregate stop loss contract.

MSF also has assumed reinsurance relationships with Argonaut Insurance Company and Legion Insurance Company related to Other States Coverage (OSC). MSF assumes risk related to Montana domiciled businesses with operations in other states, which are then covered under MSF's ceded reinsurance contract. Assumed premium for fiscal years 2008 and 2007 is $2.3M and $2.4M, respectively. The assumed liability for OSC claims is $3.9M for both fiscal years 2008 and 2007.

4. Risk Management

MSF provides liability coverage to employers for injured employees that are insured under the Workers' Compensation and Occupational Disease Acts of Montana. Workers' compensation claims occurring on or after July 1, 1990, are reported in the MSF. At June 30, 2008, approximately 27,947 active policies were insured by MSF. At June 30, 2007, approximately 28,499 active policies were insured by MSF.

MSF is a self-supporting, competitive state fund and functions as the guaranteed market insurer for employers since workers' compensation insurance is mandatory in Montana. Employers may obtain coverage through private carriers, through MSF or through self-insurance if they meet certain criteria. Public entities may self-insure or insure through MSF.

MSF serves as claim administrator on claims for injuries that occurred before July 1, 1990, known as the Old Fund. Should the reserves in the Old Fund become inadequate the State of Montana and General Fund will be obligated to cover benefit payments and administrative costs. Neither MSF nor the Old Fund had significant reductions in insurance coverage from the prior year, nor any insurance settlements exceeding insurance coverage. Unpaid claims and claims adjustment expenses are estimated based on the ultimate cost of settling the claims including the effects of inflation and other social and economic factors. When MSF purchases annuity contracts, the claim is settled in full and on a final basis, and all liability of MSF is terminated.

Towers, Perrin, Tillinghast, an external actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of June 30, 2008 and June 30, 2007. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors. A provision for inflation is implicit in the calculation of estimated future claim costs because reliance is placed both on actual historical data that reflects past inflation and on other factors that are considered to be appropriate modifiers of past experience.

Tillinghast-Towers Perrin provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected our best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2008 and 2007. The MSF estimated unpaid claims and claims adjustment expenses payable is presented at face value, net of estimated reinsurance recoverable, at $752.3M and $679.2M, as of June 30, 2008 and June 30, 2007, respectively. The estimated claims payable increased $73.1M from 2007 to 2008, which included reserve strengthening of approximately $19.9M on prior year claims. MSF currently has no knowledge of any significant environmental or asbestos claims that would contribute to this estimate.

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State law (Section 39-71-2311, MCA) requires MSF to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. Anticipated investment income is considered when computing premium rate levels. State law also requires the MSF Board of Directors to establish surplus above risk based capital requirements to secure MSF against risks inherent in the business of insurance.

Acquisition costs represent costs associated with the acquisition of new insurance contracts or renewal of existing contracts and include agent commissions and expenses incurred in the underwriting process. MSF acquisition costs are capitalized and amortized ratably over the subsequent year. Capitalized acquisition costs at June 30, 2008 and June 30, 2007 are $5.1M and $3.9M respectively. For the years ended June 30, 2008 and June 30, 2007, acquisition costs that were amortized are $3.9M and $775K, respectively.

The Old Fund covers the liability and payment of workers' compensation claims for incidents occurring before July 1, 1990. Funding for claims payments in the Old Fund is provided by the assets and investment earnings from those assets. If the assets held by the Old Fund are not adequate to fund claim payments and the administration of the Old Fund, the State of Montana and the state General Fund must fund future claims payments.

An actuarial study prepared by Tillinghast-Towers Perrin for the Old Fund as of June 30, 2008 and June 30, 2007, is used to estimate liabilities and the ultimate cost of settling claims that have been reported, but not settled, and claims that have been incurred, but not reported (IBNR). Tillinghast-Towers Perrin provides a range of potential cost associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2008 and 2007. As of June 30, 2008, the undiscounted estimated claims payable is $86.7M and is presented at net present value of $68.4M discounted at a 4.5% rate. As of June 30, 2007, the undiscounted estimated claims payable is $98.2M and is presented at net present value of $75.1M discounted at a 5.0% rate.

Changes in Claims Liabilities for the Past Two Years

The following table presents changes in the aggregate liabilities for MSF and the Old Fund for the past two years, net of estimated reinsurance recoverable. The information presented has not been discounted.

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	MSF	
	2008	**2007**
Unpaid claims and claim adjustment expenses at beginning of year	$679,209,000	$590,688,000
Incurred claims and claim adjustment expenses:		
Provision for insured events of the current year	195,324,877	189,203,678
Increase(Decrease) in provision for events in prior years	17,612,233	34,045,667
Total incurred claims and claim adjustment expenses	212,937,110	223,249,345
Payments:		
Claims and claim adjustment expenses attributable to insured events of CY	(35,772,829)	(38,677,130)
Claims and claim adjustment expenses attributable to insured events of PY	(104,119,981)	(96,051,215)
Total payment	(139,892,810)	(134,728,345)
Total unpaid claims and claim adjustment expenses at end of the year	752,253,300	679,209,000

	(OLD FUND - undiscounted)	
	2008	**2007**
Unpaid claims and claim adjustment expenses at beginning of year	98,232,540	97,768,808
Incurred claims and claim adjustment expenses:		
Provision for insured events of the current year	-	-
Increase(Decrease) in provision for events in prior years	(212,258)	11,209,186
Total incurred claims and claim adjustment expenses	(212,258)	11,209,186
Payments:		
Claims and claim adjustment expenses attributable to insured events of CY	-	-
Claims and claim adjustment expenses attributable to insured events of PY	(11,287,655)	(10,745,454)
Total payment	(11,287,655)	(10,745,454)
Total unpaid claims and claim adjustment expenses at end of the year	86,732,627	98,232,540

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Risk Management Trend Information

The following table illustrates how the earned revenues of MSF plus investment income compare to related costs of loss and other expenses assumed by MSF for fiscal years 1999 through 2008. In addition, cumulative amounts related to estimated and actual paid claims are presented. The information allows for comparison of actual and estimated claims and is a basis for developing revenue and claims information. As data for individual policy years mature, the correlation between original estimates and re-estimated amounts is used to evaluate the accuracy of incurred claims currently recognized for less mature policy years.

5. Administrative Cost Allocation

State law (Section 39-71-2352, MCA) requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to $1.25M. MSF allocated $1.25M in administration costs to the Old Fund in each of fiscal years 2008 and 2007. The Old Fund has a $126K obligation to MSF in unrecovered administrative costs incurred in fiscal years 2007 and prior. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted $1.25M.

6. MSF Distributions

The MSF Board of Directors did not authorize and MSF did not pay a dividend in fiscal year 2008. During the fiscal year ended June 30, 2007, the MSF Board of Directors authorized and MSF paid dividends to eligible policyholders of $7.0M for policy year 2005.

7. Old Fund Net Asset Position

As of December 31, 1998, a process was put in place to measure the status of the Old Fund's surplus level annually on a present value basis to determine compliance with state law requirements for maintaining fund adequacy.

Section 39-71-2352 (5), MCA, provides for the payment of excess funds from the Old Fund to the State of Montana General Fund based on adequate funding levels in the Old Fund. This law defined the term "adequately funded" to mean the present value of:

a) the total cost of future benefits remaining to be paid; and,
b) the cost of administering the claims; and,
c) adjusted for any unrealized gains and losses.

House Bill Number 363 (HB 363) enacted by the 2003 Montana Legislature requires the transfer of any amounts above the amount of "adequately funded" to the State of Montana General Fund. In addition, future excess funds would have to be transferred to the General Fund.

There were no excess funds to transfer to the General Fund as of June 30, 2008 and June 30, 2007 as a result of HB363. In order to value liabilities consistently with investments, the estimated claims liability discount rate is 4.5% in fiscal year 2008 and 5.0% in fiscal year 2007. The Old Fund net asset level, using a present value discount factor of 4.5%, is ($36.5M) as of June 30, 2008.

Using a present value discount factor of 5.0% as of June 30, 2007, the net asset level is ($32.6M). This does not indicate that the Old Fund does not have adequate financial resources to satisfy current claims obligations. Applying the current actuarially estimated payout pattern of the Old Fund there are sufficient invested assets to meet its obligations until the year 2011. Current law requires the General Fund to satisfy all outstanding claims when the Old Fund has liquidated all financial resources and cannot meet its obligations.

8. Compensated Absences

MSF supports two leave programs, the State of Montana Leave Program, (Traditional Plan) and the MSF Personal Leave Program, implemented in January 2002. The State of Montana Leave Program covers union represented employees who have elected to remain in the plan. These employees accumulate both annual leave and sick leave and MSF pays employees 100% of unused annual leave and 25% of unused sick leave upon termination. MSF also pays 100% of unused compensatory leave credits upon termination to non-exempt employees in the Traditional Plan. MSF Personal Leave Program covers all non-union employees, union employees hired before July 26, 2006 who have elected to adopt the plan, and all employees hired after July 25, 2007. Employees in the Personal Leave Program accumulate personal leave and extended leave. MSF pays employees for 100% of unused personal leave upon termination but extended leave has no cash value at the time of termination.

MSF absorbs expenditures for termination pay in its annual operational costs. MSF may allocate some of these costs to Old Fund as a portion of the Old Fund administrative cost allocation. The total leave liability for MSF and Old Fund is $2.4M and $0, respectively, for fiscal year 2008. The total leave liability for MSF and Old Fund is $2.2M and $0, respectively, for fiscal year 2007.

9. Retirement Plans

MSF and its employees contribute to the Public Employees' Retirement System (PERS), which offers two types of retirement plans administered by the Public Employees' Retirement Board (PERB). The first plan is the Defined Benefit Retirement Plan (DBRP), a multiple-employer, cost-sharing plan that provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on eligibility, years of service and highest average compensation. Vesting occurs once membership service totals five years. Benefits are established by state law and can only be amended by the legislature.

The second plan is the Defined Contribution Retirement Plan (DCRP), created by the 1999 legislature and available to all active PERS members effective July 1, 2002. This plan is a multiple-employer, cost-sharing plan that also provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on the balance in the member's account, which includes the total contributions made, the length of time the funds have remained in the plan, the investment earnings less administrative costs.

Eligible PERS members choose to participate in either the DBRP or DCRP but may not be active members of both plans. MSF and its employees are required to contribute 6.9% of annual compensation in fiscal years 2008 and 2007. MSF's contributions amounted to $1.2M for fiscal year 2008 and $1.0M for fiscal year 2007. MSF and its employees paid one hundred percent of required contributions to PERS and there is no unpaid liability as of June 30, 2008.

The PERS financial information is reported in the Public Employees' Retirement Board *Comprehensive Annual Financial Report* for the fiscal year-end. It is available from PERB at 100 North Park Avenue, Suite 220, P. O. Box 200131, Helena, MT 59620-0131, 406 444-3154.

MSF and its employees are eligible to participate in the State of Montana Deferred Compensation Plan (457 plan) administered by the PERB. The Deferred Compensation plan is a voluntary, tax-deferred retirement plan designed as a supplement to other retirement plans. Under the plan, eligible employees elect to defer a portion of their salary until future time periods. MSF incurs no costs for this plan.

10. Building

MSF currently leases an office building from the State of Montana. Under an agreement with the State of Montana, which expires on July 31, 2009, MSF pays all costs associated with the building, including utilities, property assessments, janitorial services, and maintenance plus an administrative rental fee to the State of Montana, Department of Administration.

On May 17, 2007, the State of Montana, Board of Investments (BOI) acquired land at a cost plus interest of $1,139,460 recorded as an investment of MSF assets. Under an agreement with the Board of Investments, BOI is coordinating and managing construction of an office building that MSF will occupy. Montana State Fund will pay all costs of the property including utilities, property assessments, janitorial services, and maintenance. Construction began in August 2008 and is expected to be completed in fiscal year 2010. For the year ended June 30, 2008, MSF financial statements include $1.14M in Land and $1.25M Construction Work in Process (CWIP) related to the building.

11. Other Post-Employment Benefits (OPEB)

For the fiscal year ending June 30, 2008, the State of Montana implemented Governmental Accounting Standards Board (GASB) Statement 45, Accounting and Financial Reporting by Employers for Post-employment Benefits Other Than Pensions. This statement requires the disclosure of employer liability for retiree medical subsidies and other post-employment benefits.

Post-employment Healthcare Plan Description:

MSF employees and dependents are eligible to receive health care through the State Group Benefits Plan administered by the Montana Department of Administration. In accordance with section 2-18-704, MCA, the State provides optional post-employment medical, vision and dental health care benefits to the following employees and dependents who elect to continue coverage and pay administratively established premiums: (1) employees and dependents who retire under applicable retirement provisions and (2) surviving dependents of deceased employees. For GASB 45 reporting, the State Group Benefits Plan is considered an agent multiple-employer plan and MSF is considered to be a separate employer participating in the plan.

In addition to the employee benefits described in Note 9 Retirement Plans, the following post-employment benefits are provided. Montana Department of Administration established retiree medical premiums vary between $160 and $776 per month depending on the medical plan selected, family coverage, and Medicare eligibility. Administratively established dental premiums vary between $31.00 and $53.20; vision premiums vary between $7.64 and $22.26; both premiums vary depending on the coverage selected. Basic life insurance in the amount of $14,000 is provided until age 65 at a cost of $1.90 per month to the retiree. The State Benefit Plans reimburse all validated medical claims net of member obligations (annual deductibles and coinsurance of the members' selected medical plan). Dental claims are reimbursed at 50% to 100% of the allowable charges, depending on the services provided. The State acts as secondary payer for retired Medicare-eligible claimants.

Benefits Not Included in the Valuation:

Retirees pay 100 percent of dental premiums. Thus, there is no liability for dental valued in this valuation. The vision benefit is fully-insured and retirees pay 100 percent of the cost. Thus, there is no liability for vision valued in this valuation. The life insurance benefit is a fully-insured benefit that is payable until age 65 with the retiree required to pay the full premium. There is no liability valued in this valuation for the retirees, though the required premium is an active/retiree blended premium. This liability would be insignificant to the overall results of this valuation.

Funding Policy:

The following estimates were prepared for the Department of Administration and the resulting State of Montana Actuarial Valuation of Other Post-Employment Benefits Plan (plan) contains the MSF data and is available through:
Montana Department of Administration,
State Accounting Division
Rm 255, Mitchell Bldg,
125 N Roberts St
PO Box 200102,
Helena, MT 59620-0102.

GASB 45 requires the plan's participants, including the MSF, to report each year the annual required contribution (ARC), an amount actuarially determined in accordance with the parameters of GASB Statement 45. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year of retiree health care costs and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed thirty years. The 2008 ARC is calculated for all the State plan's participants and then individually allocated to individual participants. The MSF 2008 ARC is estimated at $858,215 and is based on the plan's current ARC rate of 7.99% percent of participants' annual covered payroll. The MSF 2008 ARC is equal to an annual amount required each year to fully fund the liability over thirty years.

The amount of the estimated OPEB actuarial accrued liability at transition was determined in accordance with the GASB Statement 45, and liability is estimated at $8,079,405 for MSF. (The actuarial accrued liability is the present value of future retiree and active employees who will retire and be eligible for benefits and expenses.)

Actuarial Methods and Assumptions:

Projections of benefits for financial reporting purposes are based on the substantive plan (the plan as understood by the employer and plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between the employer and plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations. Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality, and the healthcare cost trend.

Amounts determined regarding the funded status of the plan and the annual required contributions of the employer are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future. The schedule of funding progress, presented as required supplementary information following the notes to the financial statements, presents information that shows the actuarial value of plan assets and liabilities. In the December 31, 2007, actuarial valuation, the projected unit credit funding method is used. The actuarial assumptions did not include an investment rate of return since no assets meet the definition of plan assets under GASB 43 or 45. Annual healthcare cost trend rates of 8 percent for medical and 15 percent for prescription claims are used. The unfunded actuarial accrued liability is amortized following a 30-year level percentage of payroll amortization schedule on an open basis beginning January 1, 2007.

The State finances claims on a pay-as-you-go basis and does not advance-fund the OPEB liability. While this liability is disclosed for financial statement purposes it does not represent a legal liability of the State or MSF. Therefore the following cost information shows no cost contributions or plan assets made by MSF. Since 2008 is the OPEB reporting implementation year and year of transition, there is not two years' previous information available to report as required by GASB Statement 45.

Annual OPEB Cost:

For 2008, MSF's allocated annual OPEB cost (expense) of $858,215 was equal to the ARC. The MSF annual OPEB cost, the percentage of annual OPEB cost contributed to the plan and the net OPEB obligation for 2008 are as follows:

Fiscal Year Ended	Annual OPEB Cost	Percentage of Annual OPEB Cost Contributed	Net OPEB Obligation
6/30/2008	858,215	0.00%	858,215

Funded Status and Funding Progress:

The funded status of the MSF allocation of the plan as of June 30, 2008, was as follows:

Actuarial Accrued Liability (AAL)	$8,079,405
Actuarial Value of Plan Assets	$0
Unfunded Actuarial Accrued Liability (UAAL)	$8,079,405
Funded Ratio (Actuarial Value of Plan Assets/AAL)	$0
Covered Payroll (Active Plan Members)	$16,805,676
UAAL as a Percentage of Covered Payroll	48.08%

12. Subsequent Event

The Federal National Mortgage Association and Federal Home Loan Mortgage Corp. were put into conservatorship on September 7, 2008. Lehman Brothers filed for bankruptcy protection on September 15, 2008. MSF holds two positions of Lehman Brothers Holdings, Inc., $5 million par, 2.778%, 05/25/2010 and $4 million par, 5%, 01/14/2011.

13. Contingencies

Satterlee v. Lumberman's Mutual Casualty Company et al., WCC No. 2003-0840*,* was filed before the Workers' Compensation Court on July 18, 2003. The *Satterlee, Zenahlik & Foster vs. Lumberman's Mutual Casualty Company, & Montana State Fund* case challenges the constitutionality of state statute, (39-71-710, MCA) passed by the Montana Legislature in 1981. That statute authorizes termination of permanent total disability benefits and rehabilitation benefits when a claimant receives or becomes eligible to receive full Social Security retirement benefits or an alternative to that plan. Should the statute be found to be unconstitutional as applied to permanent total benefits, *Satterlee, et al.* request payment of lifetime permanent total disability benefits. In addition, the petition requests certification of this case as a class action or the establishment of a common fund for similarly situated claimants. Petitioners filed a motion and brief for summary judgment on the constitutional issue. The Worker's Compensation Court provided an opportunity for any workers' compensation insurer to intervene until June 6, 2005. The Workers' Compensation Court rendered its decision on December 12, 2005, holding that § 39-71-710, MCA is constitutional as applied to PTD benefits. *Satterlee, et al*. appealed to the Montana Supreme Court. On December 11, 2007, Montana's Supreme Court issued an order dismissing *Satterlee et al*. without prejudice as two constitutional issues remained for ruling on by the lower court (Rule 54(b)). MSF prevailed on the additional issues (§ 39-71-710, MCA does not violate *Satterlee et al.'s* due process rights or discriminate based on age) before the Workers' Compensation Court. On July 1, 2008 *Satterlee et al.* again appealed to the Montana Supreme Court. Should § 39-71-710, MCA ultimately be held to be unconstitutional as applied to permanent total disability benefits by the Montana Supreme Court, and also found to apply retroactively, the cost impact has been estimated for non-settled claims arising on or after July 1, 1990 through December 22, 2004 at $135 million to $186 million. The estimated cost of retroactively applying the decision to the Old Fund, for non-settled permanent total disability claims that occurred before July 1, 1990 is $93 to $116 million. Actual cost impact is unknown. The potential for liability for MSF and the state of Montana is reasonably possible, but following the second Workers' Compensation Court decision in MSF's favor, the probability of liability for MSF and the state of Montana is reduced.

Working Rx, Inc*., *v. Montana State Fund, Ed Henrich, (Chairman of the Board of Directors of the Montana State Fund), Laurence Hubbard (President of the Montana State Fund), National Medical Health Card Systems, Inc, and John Does 1-20. This complaint was served in September, 2006, but has since been dismissed to provide for the presentation of the claim to the Department of Administration as required in 2-9-301, MCA. Whether Montana State Fund has any responsibility to Working Rx for payment of pharmacy claims is the basis of the claim. Montana State Fund does not have sufficient information to determine potential liability or cost impact.

Martin Heth, Jr. vs. Montana State Fund, WCC No. 2006-1758, was decided by the Workers' Compensation Court on April 25, 2008. The Workers' Compensation Court decision included the following summary: "Petitioner was in a single-vehicle accident involving the septic pumper truck he drove for his employer. Petitioner's blood-alcohol content (BAC) tested at .0874 shortly after the accident and beer cans were found in and around the truck. Respondent argued that it is not liable for Petitioner's workers' compensation claim because alcohol was the major contributing cause of the accident. Petitioner argued that alcohol was not the major contributing cause of the accident, and in any event, his employer knew that he drank alcohol on the job and therefore he is not bared from recovery under Section 39-71-407(4), MCA." The Workers' Compensation Court then held: "Although Respondent proved that alcohol was the major contributing cause of the accident, Petitioner proved that his employer knew he used alcohol while performing his job duties. Therefore, Petitioner is eligible for workers' compensation benefits." Montana State Fund appealed the Workers' Compensation Court decision to the Montana Supreme Court on June 13, 2008, and among other grounds, asserts an improper interpretation of the "employer knowledge" exception by the Workers' Compensation Court. MSF believes there is a basis for reversal of the Workers' Compensation Court decision in MSF's favor. The potential for the Supreme Court to affirm the lower court decision against MSF is probable. The estimated cost of this case should the Supreme Court affirm the lower court decision is over $1,000,000 with estimates to $2.8 million. However, actual cost would depend on evaluation of all available information at that time.

Quick vs. Montana State Fund, WCC No. 2006-1788, was decided by the Workers' Compensation Court on June 4, 2008. Quick was injured on June 15, 1984, and is a case in the "Old Fund". Quick requested retroactive and future domiciliary care benefits, a higher rate of pay for domiciliary care provided by Quick's wife, a 20% penalty, attorney fees, and costs. Quick argued Montana State Fund (MSF) was on notice that domiciliary care was required since the 1984 accident. MSF argued that it did not have notice that domiciliary care was needed until receipt of a medical opinion on February 1, 2007, stating that domiciliary care was needed. Prior to trial, MSF conceded that Quick required 24-hour domiciliary care and began paying a rate of $7.50 per hour, effective February 1, 2007. The Workers' Compensation Court held Quick is not entitled to retroactive domiciliary care prior to February 1, 2007. The court also held that the rate of

$7.50 per hour was unreasonable as the evidence establishes that Quick's care needs to be by a person with RN skills. The Court found $20.00 per hour to be a reasonable rate of pay. The Court awarded a 20% penalty on the difference of $7.50 per hour and the $20 per hour ordered by the Court on June 4, 2008. Quick appealed to the Montana Supreme Court on July 1, 2008 and Montana State Fund filed a cross- appeal on the penalty on July 15, 2008. It is remote that the Supreme Court will find additional liability for the state of Montana (this is an "Old Fund" claim) by reversing the lower court decision denying the retroactive domiciliary care. It is reasonably possible that liability will be affirmed for the penalty awarded by the lower court. The cost of this case, should the Montana Supreme Court reverse the lower court decision and award retroactive domiciliary care prior to February 1, 2007 is estimated at $1.9 million. Attorney fees would be an additional 40 % of the retroactive award.

Coles, Individually and as Personal Representatives for the Estate of Steven Bearcrane v. Black Ranches, Inc., Crow Tribal Court No. CAV 07-044, is a tort case filed against a policyholder of Montana State Fund. The case involves a wrongful death claim by the estate of an employee of the policyholder. Montana State Fund is providing a defense under a complete reservation of rights to the policyholder under Part Two of the State Fund's insurance policy, also known as the employers' liability coverage. The policy limits in this case are $1,000,000. The exclusive remedy provisions of MCA § 39-71-411 should bar this type of tort claim against the policyholder. However, if the plaintiffs are successful in convincing the court that MCA § 39-71-411 does not provide a defense, that the employer-policyholder was at fault in causing the death of its employee, and that the State Fund's policy provides indemnity, the damages to be awarded may be substantial. Actual potential cost impact to the State Fund is not known at this time. Liability for Montana State Fund, up to policy limits, is reasonably possible.

Montana State Fund also is involved in a great deal of litigation in the areas of workers' compensation and disputes with policyholders. These are of a generally routine nature and there are no known matters at this time that will have a large and widespread financial impact.

Montana State Fund

(A Component Unit of the State of Montana)

Notes to Financial Statements

June 30, 2008 and 2007

Schedule of Funding Progress for MSF

Other Post-Employment Benefits (Financial Statements Note 11)

The following table shows only information for the most recent, completed fiscal year which is the fiscal year ended June 30, 2008. Since 2008 is the OPEB reporting implementation year and year of transition, there is not two years' previous information available to report as required by Governmental Accounting Standards Board Statement 45.

Date	Actuarial Value of Assets (A)	Actuarial Accrued Liability (AAL) (B)	Unfunded AAL (UAAL) (B-A)	Funded Ratio (A/B)	Covered Payroll (C)	UAAL as a Percentage of Covered Payroll ((B-A)/C)
6/30/2008	$0	$8,079,405	$8,079,405	0.00%	$16,805,676	48.08%

Projected unit credit funding method

Montana State Fund

Fund's Response

MONTANA STATEFUND

5 South Last Chance Gulch • P.O. Box 4759 • Helena, MT 59604-4759
Customer Service: 1-800-332-6102 or 406-444-6500
Fraud Hotline: 1-800-682-7463 (800-MT-CRIME)

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LEGISLATIVE AUDIT DIV.

December 1, 2008

Ms. Tori Hunthausen
Legislative Audit Division
Room 160, State Capitol
Helena, MT 59620-1705

Dear Ms. Hunthausen:

Montana State Fund (MSF) appreciates the efficient and professional approach of the audit staff involved in this review of our governmental financial statements. We are pleased with the unqualified opinion on the financial statements we have presented.

While there are no audit recommendations, this report includes disclosure information regarding the accounting for the office building currently under construction. Our financial statements for the previous year included an investment in real estate for the land the Board of Investments (BOI) purchased in May 2007. These statements also disclosed that BOI would be coordinating the construction of a building that MSF would occupy. The allocation of MSF assets to real estate by BOI remains appropriate because of the specific legal requirements, both in law and in the state constitution. Article VIII, Section 13 of the Montana Constitution provides for the Unified Investment Program administered by the BOI, and states the assets of MSF shall be managed by BOI as a *"private insurance organization."* State law providing the guidance for investments and investment practices of property and casualty insurers, such as Montana State Fund, allows for an investment in a building when used in the insurer's business operations.

The management and staff of MSF are very proud of our continued accomplishments in serving Montana businesses. We continually strive to improve our operations to ensure Montana businesses and the community will continue to benefit from a strong Montana State Fund many years into the future.

Sincerely,

Laurence A. Hubbard
President/CEO

Montana's insurance carrier of choice and industry leader in service

Our mission is to be Montana's insurance carrier of choice and industry leader in service.